C. DUKES SCOTT
EXECUTIVE DIRECTOR

DAN F. ARNETT
CHIEF OF STAFF

P.O. Box 11263
Columbia, S.C. 29211

Phone: (803) 737-0800
Fax: (803) 737-0801

January 31, 2008

VIA EFILING AND HAND DELIVERY

Mr. Charles L.A. Terreni
Chief Clerk/Administrator
Public Service Commission of South Carolina
101 Executive Center Dr., Suite 100
Columbia, SC 29210

Re: Commission December 12, 2007 Directive
ND-2007-5-E

Dear Mr. Terreni:

Pursuant to the Commission's Directive of December 12, 2007, the Office of Regulatory Staff ("ORS") provides its review and recommendation as well as a copy of the report prepared by Duke Energy Carolinas, Inc., and provided to ORS staff.

If the Commission requires any further information from ORS, please notify us.

Please date stamp the one extra copy for our office and return it to me via our courier and do not hesitate to let me know if you have any questions.

Sincerely,

Nanette S. Edwards

Nanette S. Edwards

Enclosure

cc: Frank Ellerbe, III Esquire
Lara. S. Nichols, Esquire

SOUTH CAROLINA OFFICE OF REGULATORY STAFF REVIEW AND RECOMMENDATION TO THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

ND 2007-5-E
January 31, 2008

SOUTH CAROLINA
OFFICE OF REGULATORY STAFF

REVIEW AND RECOMMENDATION TO THE
PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

On December 12, 2007, the Public Service Commission of South Carolina ("Commission") issued a Directive requesting the Office of Regulatory Staff ("ORS") to provide a written report to the Commission by January 31, 2008 concerning the North Carolina Utilities Commission's ("NCUC's") Order in Docket Nos. E-7, SUB 828; E-7, SUB 829; and E-100, SUB 112 and their relevance to Duke Energy Carolinas, LLC's rates and provision of service in South Carolina. Pursuant to S.C. Code Ann. §58-4-50(A)(6), ORS submits its findings and recommendations as set forth below in response to the Commission's request for information.

By letter dated December 19, 2007, ORS requested Duke Energy Carolinas, LLC ("Duke") to provide information regarding the North Carolina Order dated November 29, 2007, in Docket Nos. E-7, SUB 828; E-7, SUB 829; and E-100, SUB 112 and any subsequent orders.

Attached as Appendix A is the letter from ORS to Duke requesting information in response to the Commission's Directive and Duke's response.

In addition to analyzing the information supplied by Duke, ORS reviewed the following NCUC Orders and documents:

- Notice of Decision and Order, Dated November 29, 2007– Docket Nos. E-7, SUB 828; E-7, SUB 829; and E-100, SUB 112
- Order Approving Stipulation and Deciding Non-Settled Issues, Dated December 20, 2007 - Docket Nos. E-7, SUB 828; E-7, SUB 829; E-100, SUB 112; and E-7, SUB 795
- Order Approving Rate Schedules and Public Notice, Dated December 28, 2007 - Docket Nos. E-7, SUB 828; E-7, SUB 829; E-100, SUB 112; and E-7, SUB 795
- Order Approving Implementation of the Merger Savings Rider Subject to Refund, Dated December 28, 2007 - Docket Nos. E-7, SUB 828; E-7, SUB 829; E-100, SUB 112; and E-7, SUB 795
- Letter from NC Public Staff to NCUC regarding rate increment rider effective January 1, 2008, Dated December 28, 2007 - Docket Nos. E-7, SUB 828; E-7, SUB 829 and E-100, SUB 112
- Duke Filing pursuant to Decretal Paragraphs 3 and 15 of the NCUC's December 20, 2007 Order Approving Stipulation and Deciding Non-Settled Issues, Dated January 3, 2008 - Docket Nos. E-7, SUB 828; E-7, SUB 829; E-100, SUB 112; and E-7, SUB 795
- Duke Energy Carolinas' Comments on Reconsideration, Dated January 11, 2008 – Docket Nos. E-7, SUB 828 and E-7, SUB 795
- Comments of the Public Staff on the Commission's Reconsideration of the Merger Condition, Dated January 11, 2008 - Docket Nos. E-7, SUB 828 and E-7, SUB 795
- Duke Energy Carolinas' Motion for Clarification and in the Alternative Motion for Extension of Time to File Notice of Appeal and Exceptions, Dated January 16, 2008 – Docket Nos. E-7, SUB 795; E-7, SUB 828; E-7, SUB 829; and E-100, SUB 112
- Duke Filing pursuant to Decretal Paragraphs 3 and 15 of the NCUC's December 20, 2007 Order Approving Stipulation and Deciding Non-Settled Issues (Revised Depreciation/Amortization Schedule), Dated January 21, 2008 – Docket Nos. E-7, SUB 828; E-7, SUB 829; and E-100, SUB 112.
- North Carolina Attorney General Reply Comments, Dated January 25, 2008 – Docket Nos. E-7, SUB 828 and E-7 SUB, 795

- North Carolina Public Staff Reply Comments, Dated January 25, 2008 – Docket Nos. E-7, SUB 828, and E-7, SUB 795
- Carolina Utility Customers Association (CUCA) Reply Comments, Dated January 25, 2008 – Docket Nos. E-7, SUB 795; E-7, SUB 828; E-7, SUB 829; and E-100, SUB 112.

ORS also examined the Commission's Order Approving Stipulations and Merger, Order No. 2005-684 in Docket No. 2005-210-E dated December 7, 2005. Specifically, ORS revisited the Most Favored Nation ("MFN") language on page 2 of Order Exhibit 2 which states as follows:

> Following approval of the Merger by the state commissions of North Carolina, and Ohio, and approval of the affiliate agreements filed with the Indiana Utility Regulatory Commission in connection with the Merger, any sharing mechanisms pursuant to which merger savings are shared with retail customers in each of these states will be reviewed to identify the utility whose electric retail customers will receive ***the largest percentage of the net merger savings to be achieved over the first five years after closing of the merger allocated to that utility.*** If the application of that percentage to the net savings allocable to South Carolina retail would result in a greater savings sharing than $40 million, then the rate reduction . . . for South Carolina retail customers will be increased to match the application of that percentage to the net savings allocable to South Carolina retail. [Emphasis added].

This review addresses two issues: (I) Do the orders issued by the NCUC in the above referenced dockets trigger the MFN provision of the Stipulation approved by this Commission? and (II) What is the underlying rationale for the $286,924,000 rate reduction?

I. Most Favored Nations Provision

It is the position of ORS that the MFN provision is not triggered by the actions taken in the North Carolina rate case proceeding because the appropriate time to determine the largest percentage of the merger savings to be allocated to electric retail customers was following the issuance of the merger orders, not in a subsequent rate case proceeding. The MFN language negotiated by ORS in the Stipulation reached by ORS, SCEUC, and Duke contemplated that a review and comparison of the percentage of the merger savings allocated to electric retail customers for each state would occur following the issuance of the merger orders in North Carolina and Ohio and the approval of the affiliate agreements issued in Indiana. As part of its negotiations to reach the Stipulation, ORS did not intend or contemplate at the time of those negotiations that a subsequent general rate case proceeding could be used to trigger the MFN provision. Notwithstanding the above, a review of the orders issued by the NCUC and referenced in more detail below, reveals that the NCUC has maintained a 42% ratepayer/58% shareholder allocation of the merger savings.

Based on the information supplied by Duke, ORS's independent review of the documents referenced herein, and conversations with legal counsel for

the North Carolina Public Staff, ORS concludes that the NCUC's Orders in Docket Nos. E-7, SUB 828; E-7, SUB 829; E-100, SUB 112; and E-7, SUB 795 do not trigger the MFN provision of the Stipulation reached between ORS, Duke and the South Carolina Energy Users Committee ("SCEUC") and approved by the Commission.

The NCUC has not modified its Merger Order[1] in such a manner as to alter the effect of a 42%/58% allocation of the net merger savings between Duke's North Carolina electric retail customers and its shareholders. The $117.5 million rate decrement approved pursuant to the North Carolina Merger Order represented 42% of the forecasted merger savings. As a part of the rate case, test year operating expenses were adjusted to reflect merger savings actually experienced on an annualized basis by the Company. (NCUC Order Dated December 20, 2008 at pages 35-38). As a result of that adjustment the NCUC also preliminarily approved a rate increment of approximately $80,459,000 (referred to as the "Merger Savings Rider") effective January 1, 2008 to permit Duke's shareholders to receive a fair sharing of the benefits of the merger savings. (NCUC Order Dated December 20, 2008 at page 36). The NCUC found that the amount of $80,459,000 represents 58% of the annualized level of gross merger savings

[1] *Order Approving Merger Subject to Regulatory Conditions and Code of Conduct*, NCUC Docket No. E-7, Sub 795 (March 24, 2006) ("Merger Order")

of $46,241,000 reflected in rates for the next three calendar years. (Id. at page 36). ORS notes that the NCUC's Order Approving Implementation of the Merger Savings Rider Subject to Refund dated December 28, 2007, permits Duke to implement the rider subject to refund and interest if the NCUC does not ultimately confirm its preliminary conclusion regarding the Merger Savings Rider.

ORS has monitored and will continue to monitor the rulings of the North Carolina Utilities Commission, the Public Utilities Commission of Ohio, and the Indiana Utility Regulatory Commission.

II. North Carolina Rate Reduction

Again, based on information provided by Duke and ORS's review of the North Carolina orders referenced above, Duke's North Carolina rate reduction of $286,924,000, is predominately a result of: (1) the change in the rate treatment of costs associated with the North Carolina Clean Smokestacks Act; (2) the longer levelization period (over 15 years) of capacity purchases from the Catawba Nuclear Station; and (3) the adoption of an 11% return on equity ("ROE").

With regard to North Carolina's recent adoption of an 11% ROE, ORS notes that over the last four quarters ending September 30, 2007, the average pro forma ROE for Duke in South Carolina is 10.61%.

III. Conclusion

In conclusion, based on the information obtained from Duke, conversations with counsel for Public Staff, and the other information reviewed by ORS, the recent actions taken by the NCUC in Docket Nos. E-7, SUB 828; E-7, SUB 829; E-100, SUB 112; and E-7, SUB 795 have not triggered the MFN provisions approved by Order No. 2005-684. ORS has monitored and will continue to monitor the orders related to the Duke/Cinergy merger savings issued by the North Carolina, Ohio, and Indiana utilities commissions. As further detailed in Duke's report attached as Appendix A, Duke's rate reduction in North Carolina is the result of at least three main factors: (1) the change in the rate treatment of costs associated with the North Carolina Clean Smokestacks Act which was 100% allocated to North Carolina; (2) the longer levelization period utilized in North Carolina as compared to South Carolina of the capacity purchases from the Catawba Nuclear Station; and (3) the recent adoption of an 11% ROE.

Respectfully submitted,

Nanette S. Edwards, Esquire
OFFICE OF REGULATORY STAFF
1441 Main Street, Suite 300
Columbia, South Carolina 29201
Phone: (803) 737-0575
Fax: (803) 737-0895
nsedwar@regstaff.sc.gov

APPENDIX A

Appendix A

C. DUKES SCOTT
EXECUTIVE DIRECTOR

DAN F. ARNETT
CHIEF OF STAFF

P.O. Box 11263
Columbia, S.C. 29211

Phone: (803) 737-0800
Fax: (803) 737-0801

December 19, 2007

VIA HAND DELIVERY

Mr. Frank Ellerbe, III
Robinson, McFadden & Moore, P.C.
1901 Main Street, Suite 1200
Columbia, South Carolina 29202

Re: Inquiry of the South Carolina Public Service Commission Concerning NCUC Dockets E-7, Sub 828, E-7, Sub 829 and E-100, Sub 112 and the Rates and Service of Duke Energy Carolinas in South Carolina.
Docket No. ND-2007-5-E

Dear Frank:

We understand that you are representing Duke Energy Carolinas in connection with the December 12, 2007 Directive of the South Carolina Public Service Commission which requested information on the relevance of certain orders in dockets of the North Carolina Utilities Commission to the rates and service of Duke Energy Carolinas in South Carolina.

Pursuant to S.C. Code Ann. §58-4-50(A)(6) the Office of Regulatory Staff is gathering information in order to make a recommendation to the Commission with respect to its Directive. We request that Duke Energy Carolinas prepare and submit a report to this office discussing the North Carolina dockets referenced in the Directive, the actions taken by the North Carolina Utilities Commission in those dockets, and the relevance, if any, of those actions to the rates or service of Duke Energy Carolinas in South Carolina. We do not request an exhaustive explanation of every issue involved in the North Carolina proceedings but request that the Company focus on the issues which could have relevance to its South Carolina operations.

If you or the Company have questions about this request please let us know. We may be contacting you to request specific information or documents as we proceed with our inquiry.

Sincerely,

Nanette S. Edwards

Nanette S. Edwards

ND-2007-5-E

DUKE ENERGY CAROLINAS' REPORT TO THE OFFICE OF REGULATORY STAFF REGARDING NCUC DOCKET NOS. E-7, SUB 828, E-7, SUB 829, AND E-100, SUB 112

January 21, 2008

I. INTRODUCTION

On December 12, 2007, the South Carolina Public Service Commission ("SCPSC" or "Commission") issued its Directive requesting a report concerning North Carolina Utilities Commission ("NCUC") Docket Nos. E-7, Sub 828, E-7, Sub 829 and E-100, Sub 112 ("North Carolina Dockets") and the relevance of actions taken by the NCUC in those dockets to Duke Energy Carolinas' rates and provision of service in South Carolina. In sum, the NCUC approved a stipulation between Duke Energy Carolinas, LLC ("Duke Energy Carolinas" or "Company") and other parties in the North Carolina Dockets that, among other things, provided for a reduction in rates for the Company's North Carolina retail customers. In connection with the Commission's Directive, the South Carolina Office of Regulatory Staff ("ORS") requested that Duke Energy Carolinas provide it with information concerning the North Carolina dockets. Duke Energy Carolinas provides this Report in response to the ORS' request.

II. SUMMARY REPORT

A. Conclusion

The NCUC issued its Order Approving Stipulation and Deciding Non-Settled Issues ("NC Rate Order") in the North Carolina Dockets on December 28, 2007. The NC Rate Order does not warrant any action by this Commission because: (1) the overwhelming driver of the North Carolina rate decrease is a change in the rate treatment of costs associated with the North

Carolina Clean Smokestacks Act ("Act"), which costs are not currently included in Duke Energy Carolinas' South Carolina cost of service and rates; (2) Duke Energy Carolinas' South Carolina quarterly earnings reports over the last three years reflect rates of return on equity ("ROE") that are on average below the ROE authorized by the Commission in the Company's most recent rate case. They also are on average below the ROE authorized by the NCUC in the NC Rate Order and by the SCPSC for South Carolina Electric & Gas Company in recent rate cases; (3) the NCUC's treatment of merger savings in the NC Rate Order does not trigger the "most favored nation" ("MFN") provision adopted in the SCPSC's order approving the Duke Energy Corporation/Cinergy Corporation merger ("Merger"); and (4) the remaining issues addressed in the NC Rate Order are specific to North Carolina and are not relevant to rates and service in South Carolina.

B. Background

Duke Energy Carolinas filed the 2007 North Carolina rate case in compliance with a regulatory condition contained in the NCUC's 2006 order[1] approving the Merger. The NCUC concluded that given the change in the Company's organizational structure and the complexity of the merger and regulatory conditions, it required the Company to file a general rate case in 2007 or demonstrate that its existing rates were just and reasonable. However, the NCUC made clear that it had made no determination that the rates being charged at that time were in fact unjust or unreasonable. In the NC Merger Order, the NCUC also adopted certain provisions of a stipulation between Duke Energy Carolinas and the NCUC Public Staff. The stipulation included the Company's proposal to share with customers, through a 12-month decrement rider,

[1] *Order Approving Merger Subject to Regulatory Conditions and Code of Conduct*, NCUC Docket No. E-7, Sub 795 (March 24, 2006) ("NC Merger Order").

42% of the five-year projected net merger savings assignable to its North Carolina retail customers – the same sharing percentage implemented in South Carolina. The NCUC adopted a MFN provision similar to the one adopted in South Carolina.

As also required by the NCUC merger order, the 2007 North Carolina rate proceeding was combined with a proceeding required by the North Carolina Clean Smokestacks Act to review Duke Energy Carolinas' environmental compliance costs under the Act and to determine the appropriate recovery method for costs that had not yet been recovered through accelerated amortization. The Company initially filed a request for a 3.6% rate increase of $140 million. Expert witness Dr. James H. Vander Weide supported an ROE of 12.5%. The test year expenses included $225 million in amortization expense for environmental compliance costs. The filing also included pro forma adjustments related to costs to achieve the Merger and merger savings.

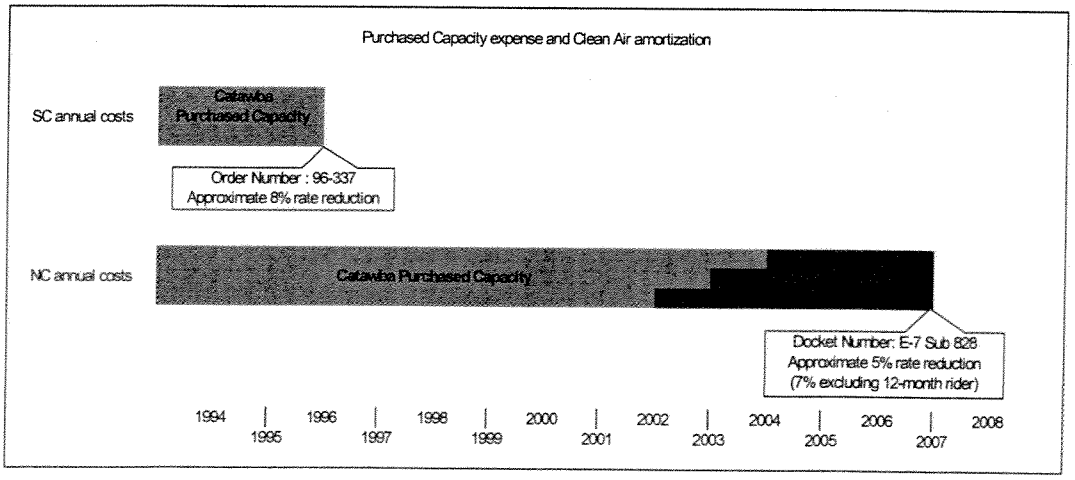
All of the parties to the rate proceeding executed an Agreement and Stipulation of Partial Settlement ("NC Stipulation"). The NC Rate Order approved the NC Stipulation and ultimately resulted in an overall average rate decrease of 5% in 2008, increasing to 7% upon expiration of a one-time 12-month rate rider. As a part of the settlement Duke Energy Carolinas was able to address rate parity issues. The average rate decreases by customer class are 11% for the industrial class; 5% for the general service class and 3% for the residential class in 2008, increasing to 16% industrial; 7% general service and 5% residential upon expiration of the rider.

C. Primary Driver of North Carolina Rate Reduction

Under the NC Stipulation, the parties agreed to eliminate the accelerated amortization expense for environmental compliance cost in favor of traditional rate making treatment of these capital additions. This change provided the primary driver of the rate decrease. The accelerated

amortization expenses incurred by the Company from 2003 through 2007 under the North Carolina Clean Smokestacks Act were allocated 100% to North Carolina retail customers.

Through 2004, the Company's North Carolina cost of service included expenses associated with the levelization of capacity purchases from the Catawba Nuclear Station ("Catawba") co-owners. In previous rate cases, the NCUC authorized that such costs be levelized over 15 years; however, the SCPSC authorized a shorter levelization period of seven and one-half years. Further, the SCPSC required a true-up to adjust rates at the end of the levelization period. Accordingly, in 1996, South Carolina customers received an 8% rate decrease in the form of a decrement rider. This decrement rider remains in place today. In contrast, the NCUC did not reduce rates in North Carolina at the end of the levelization period. Instead, the accelerated amortization expenses for the North Carolina environmental costs effectively replaced the levelized capacity expenses resulting in a continuation of the existing North Carolina retail base rates through the end of 2007. As a result of these historic rate and legislative actions resulting in differing levels of Catawba levelization and environmental compliance costs, the Company's cost of service in South Carolina was significantly different from its North Carolina cost of service. This difference is shown in the illustration below:



Duke Energy Carolinas' North Carolina rates after the reduction (which approximates the South Carolina rate reduction in 1996) are now comparable to its South Carolina rates.

D. Rate of Return on Equity

Duke Energy Carolinas' currently authorized ROE in South Carolina is 12.25%. In the NC Dockets, considering the settlement as a whole and in the interest of compromise, the parties to the NC Stipulation agreed to an 11.0% ROE, which the NCUC found to be just and reasonable as part of the overall settlement. Similarly, the SCPSC authorized rates of return on equity for South Carolina Electric and Gas Company of up to 11.4% and up to 11.0% in 2004 and 2007 respectively. Over the last three years, Duke Energy Carolinas' average ROE as reported in its South Carolina quarterly earnings reports is 10.63% as shown in the following chart.

Quarterly Filings
2005 through 2007

First Quarter 2005	11.58%
Second Quarter 2005	10.93%
Third Quarter 2005	12.00%
Fourth Quarter 2005	10.56%
First Quarter 2006	10.86%
Second Quarter 2006	9.69%
Third Quarter 2006	8.83%
Fourth Quarter 2006	10.79%
First Quarter 2007	10.37%
Second Quarter 2007	9.74%
Third Quarter 2007	11.53%
Average filed return	10.63%

Therefore, the Company's actual earnings experience is not only less than its currently authorized ROE in South Carolina, but also consistent with the ROE authorized by the NC Rate Order and the ROEs approved by the SCPSC in the most recent SCE&G rate cases.

E. Most Favored Nation Provision

The South Carolina MFN provision, as negotiated by the Office of Regulatory Staff was included as part of the merger approval to ensure that South Carolina customers were not disadvantaged and did not receive a lesser share of savings by virtue of the SCPSC having issued its approval of the merger earlier than the other jurisdictions.[2] The appropriate time period for determining whether South Carolina's level of shared savings was equivalent to other jurisdictions was at the time of consummation of the Merger, not some later time period or some subsequent general rate case proceeding in another jurisdiction. At the time of the approval of the Merger, the NCUC adopted the same sharing percentage as South Carolina and a similar MFN provision. In fact, the NC Merger Order made clear that the NCUC "has been careful to adopt no condition which will trigger any of [the MFN] provisions" in the other jurisdictions.[3]

The treatment of merger savings in the North Carolina rate case was based on the NCUC's review of the Company's total costs of service, including operating expenses and merger savings, during the test period and did not involve any reconsideration of whether the Merger should be approved. The NC Merger Order included a condition addressing how merger costs and savings should be reflected in the Company's test year cost of service in the rate proceeding. The NCUC concluded Duke Energy Carolinas' test period operating costs should reflect an annualized level of merger cost savings actually experienced in the test period because

---

[2] Order Approving Stipulations and Merger, Docket No. 2005-210-E; Order No. 2005-684 (December 7, 2005) ("Merger Order"), Order Exhibit 2 at p. 2.

rates should be designed to recover a reasonable and prudent level of ongoing expense. This interpretation is consistent with the South Carolina MFN provision. This one state commission's review of Duke Energy Carolinas' cost of service in a rate case does not trigger the MFN provisions.

III. DETAILED REPORT

This Detailed Report provides (1) a description of the North Carolina Dockets; (2) a summary of the NC Rate Order; (3) information concerning the Company's rates and revenues in South Carolina as compared with its rates and revenues in North Carolina; (4) a discussion of the "most favored nation" provision adopted by this Commission in its order approving business combination transaction between Duke Energy Corporation and Cinergy Corporation; and (5) legal analysis regarding the relevance of the NC Rate Order on South Carolina rates and service.

A. The North Carolina Dockets

Duke Energy Carolinas' most recent North Carolina rate case prior to the dockets addressed in this Report was decided on November 12, 1991, in NCUC Docket No. E-7, Sub 487. In the 1991 case, the NCUC approved rates and charges designed to allow Duke Energy Carolinas the opportunity to earn a rate of return of 12.5% on the common equity component of its North Carolina jurisdictional rate base. Under the North Carolina Clean Smokestacks Act, N.C. Gen. Stat. § 62-133.6, the rates of Duke Energy Carolinas were frozen, subject to certain exceptions, for a period commencing July 1, 2002, and ending December 31, 2007. The Act required Duke Energy Carolinas to amortize as a North Carolina retail expense by December 31, 2007, $1,050,000,000 of environmental compliance costs incurred under the Act. The Act also

---

[3] *Id.* at p. 75.

required that the NCUC hold a hearing prior to the end of the rate freeze period to review the environmental compliance costs incurred under the Act.

The NCUC issued the NC Merger Order in Docket No. E-7, Sub 795 with respect to the proposed business combination transaction between Duke Energy Corporation and Cinergy Corporation ("Merger") on March 26, 2006. In that order the NCUC approved the Merger, subject to a series of regulatory conditions. Given the change in the Company's organizational structure and the complexity of the merger and regulatory conditions, one such condition required the Company in 2007 to file a general rate case or demonstrate that its existing rates were just and reasonable, using a test period consisting of the twelve months ending December 31, 2006. However, the NCUC made clear that it had made no determination that the rates being charged at that time were in fact unjust or unreasonable. This rate action was to be consolidated with the NCUC's review of the Company's environmental compliance costs pursuant to N.C. Gen. Stat. § 62-133.6. The NCUC instituted Docket Nos. E-7, Subs 828 and 829 to address these issues.[4]

The Company initially filed a request for a 3.6% rate increase of $140 million. Expert witness James H. Vander Weide supported a ROE of 12.5%. The test year expenses included $225 million in amortization expense for environmental compliance costs. The filing also included pro forma adjustments related to cost to achieve the Merger and merger savings. Duke Energy Carolinas advocated that the rate increase was necessary to maintain the Company's financial strength as it began a period of major capital expenditures in order to modernize and

[4] In addition, on January 23, 2007, the NCUC initiated generic Docket No. E-100, Sub 112, dealing with the accounting treatment of cost deferrals pursuant to Statement of Financial Accounting Standards No. 158 ("SFAS 158"). It subsequently consolidated that docket with Docket Nos. E-7, Subs 828 and 829, for the purpose of receiving evidence on the issue of whether the treatment of deferrals under SFAS 158 by Duke Energy Corporation required approval under the NCUC rules.

expand its generation fleet and transmission and distribution systems. The Company proposed a three phase plan for implementing the rate increase in order to improve rate parity among its customer classes, with industrial customers ultimately receiving a rate decrease.

B. Summary of the NC Rate Order

The NC Rate Order adopted and approved the NC Stipulation, which constituted the compromise and settlement of the diverse interests of all parties to the rate application, including two agencies charged with representing the using and consuming public, two industrial customer groups, and a major commercial customer. In approving the NC Stipulation, the NCUC authorized an overall rate of return of 8.57% and a return on common equity of 11% using a capital structure of 47% long-term debt and 53% common equity. The NC Stipulation provided for an annual revenue decrease of $233,000,000 based on an adjusted test year cost of service for the calendar year ended December 31, 2006. It also provided for rates be designed to provide the industrial class with a decrease in base rates of 12.7%, the residential class a rate reduction of 3.85%, and the general service class rate reductions between 5.05% and 7.34%.[5] NC Rate Order at p. 9-10.

---

[5] In addition, the NC Stipulation addressed the following issues:

- nuclear insurance reserves;
- normalization of test period storm restoration costs;
- depreciation rates and nuclear decommissioning costs;
- revenue requirements by customer class;
- the migration of Nantahala Area customers to Duke Energy Carolinas tariffs;
- the computation of the Company's base fuel factor;
- the treatment of bulk power marketing and non-firm transmission net revenues;
- construction work in progress expenditures associated with the new Cliffside generating plant;
- environmental compliance costs under the Clean Smokestacks Act;
- accounting for the over-funded or under-funded status of defined benefit pension plan obligations and other post-retirement benefit obligations in a manner that complies with the SFAS 158;
- the continued use of summer coincident peaks for cost allocation;
- rate design and service regulations;
- treatment of existing demand-side management and energy efficiency programs; and

The NC Rate Order continues the NCUC's past practice (which has also been the practice of the SCPSC) of basing jurisdictional allocations on the Company's summer coincident peak demand. NC Rate Order at p. 11. This is relevant to the Company's South Carolina rates in that it assures that, if the SCPSC continues to apply that allocation methodology, there will be no overlap or gap in the allocation of demand costs.

The NC Stipulation left four issues to be decided by the NCUC: (1) the appropriate treatment of merger savings occurring during the test year; (2) the appropriateness of the Company's proposed amortization of its GridSouth development costs; (3) the appropriate docket in which to address the Company's Interruptible Service program; and (4) proposed changes to the Company's service regulations presented by the North Carolina Attorney General. The NC Stipulation provided that any additional revenue adjustments resulting from the NCUC's decision on these issues would be allocated to the customer classes pro rata to the agreed upon reductions.

With respect to the issues not included in the NC Stipulation, the NCUC required that Duke Energy Carolinas' test period operating costs reflect an annualized level of the merger cost savings actually experienced in the test period in keeping with traditional principles of ratemaking. Additionally, the NCUC found that, because rates should be designed to recover a reasonable and prudent level of ongoing expense, the Company's annual cost of service and revenue requirement should reflect, as closely as possible, the Company's actual costs. NC Rate Order at p. 35.

However, the NCUC recognized that, based upon the evidence presented, its treatment of merger savings would not produce a fair result. The NCUC recognized that the Company's

---

- the quality of electric service provided by the Company.

shareholders have borne "significant costs and risks" in conjunction with the Merger and "should receive the benefit of additional merger savings." The NCUC also states that it desires "to avoid discouraging business combinations that, over the long term, lower costs that ratepayers must bear." Therefore, the NCUC preliminarily concluded that it would reconsider certain language[6] in the regulatory conditions adopted in the NC Merger Order to allow it to authorize an increment rider designed to provide a more equitable sharing of the actual merger savings achieved on an ongoing basis. NC Rate Order at pp. 35-36.

With respect to the recovery of GridSouth costs, the NCUC concluded that such costs were reasonable and prudent and approved a ten-year amortization beginning June 2002 of GridSouth costs incurred through June 2002. NC Rate Order at pp. 53-59. The NCUC also decided the remaining non-settled issues in Duke Energy Carolinas' favor.

As a result of its decision on the non-settled issues, the NCUC ordered an additional reduction in annual revenues of $53,924,000, offset by its preliminary conclusion to reconsider the NC Merger Order in order to authorize a 12-month increment rider in the amount of $80,459,000.[7] The NC Rate Order ultimately resulted in an overall average rate decrease of 5% in 2008, increasing to 7% upon expiration of the one-time merger savings rate increment rider. The average rate decreases by customer class are 11% for the industrial class; 5% for the general

---

[6] The language at issue is as follows:

> Nor will any portion of the net merger savings attributed to shareholders by Duke Energy be eligible for recovery from North Carolina retail ratepayers in base rates, rate riders, or other cost recovery mechanisms set prospectively subsequent to consummation of the Merger. . . .

[7] In compliance with N.C. Gen. Stat § 62-80 governing reconsideration of prior NCUC orders, the NCUC established a procedural schedule to provide notice and an opportunity to comment on its preliminary conclusion to reconsider the specified language in the regulatory conditions. The NCUC permitted Duke Energy Carolinas to include the $80,459,000 in the rates effective January 1, 2008, subject to refund. However, no party filed comments objecting to the NCUC's preliminary conclusion to reconsider this language. A final order is expected in February 2008.

service class and 3% for the residential class in 2008, increasing to 16% industrial; 7% general service and 5% residential upon expiration of the rider.

These myriad and complex issues addressed in the North Carolina proceedings have limited, if any relevance to the rates and provisions of service in South Carolina. However, the change in rate treatment of North Carolina Clean Smokestacks Act costs, the newly authorized ROE and the decision relating to merger savings merit further discussion.

C. Discussion

1. The NC Rate Decrease Is Driven By North Carolina Clean Smokestacks Act Costs

The North Carolina rate case was consolidated with and is intrinsically linked to the NCUC's required review of environmental compliance costs and determination of the recovery mechanism for such costs. The most significant adjustment contributing to the rate decrease to North Carolina customers is the adjustment to eliminate $225,200,000 in amortization expense relating to environmental compliance costs from the test year cost of service. The North Carolina Clean Smokestacks Act, N.C. Gen. Stat. § 62-133.6, enacted June 20, 2002, implemented more stringent limitations on nitrogen oxide (NOx) and sulfur dioxide (SO2) emissions from coal-fired generating units which must be met by emissions reductions rather than through use of emissions allowances. These "hard caps" required significant investment in emissions control technology.

The Act included cost estimates for compliance and provided that the investor-owned utilities subject to the Act shall be allowed to accelerate the cost recovery of such estimates over a seven-year period beginning January 1, 2003. As noted above, pursuant to the Act, the rates of Duke Energy Carolinas were frozen, subject to certain exceptions, for a period commencing July

1, 2002, and ending December 31, 2007. During that time, the Company amortized $1,050,000,000 in environmental compliance costs and allocated 100% of this expense to its North Carolina retail customers. Since the passage of the Act, however, the federal Clean Air Interstate Act and Clean Air Mercury Rule were enacted and provide emissions limitations that eclipse those included in the North Carolina Clean Smokestacks Act.

Duke Energy Carolinas incurred environmental compliance costs in the amount of $901,380,485 through December 31, 2006. Duke Energy Carolinas included $225,200,000 million of environmental compliance amortization expense in its initial filing in the rate proceeding. In the NC Stipulation, the parties agreed to eliminate this amount from test period cost of service, and instead each party agreed that it will not contest the inclusion in rate base of all reasonable and prudent unamortized environmental compliance costs allocated to North Carolina retail as the specific projects are closed to plant in service. Duke Energy Carolinas believes that this treatment is appropriate in light of the subsequent enactment of more stringent federal standards that will become effective beginning in 2009. This change from accelerated cost recovery to traditional rate base treatment of these costs accounts for the majority of the decrease in North Carolina base rates. The NC Rate Order concludes that this treatment is just and reasonable. Rate Order at p. 14.

2. South Carolina Customers Received a Similar Rate Decrease in 1996 Related to Catawba Levelization Costs

Through 2004, the Company's North Carolina cost of service included expenses associated with the levelization of capacity purchases from the Company's Catawba Nuclear Station ("Catawba") co-owners. In connection with the sale of partial ownership interest in Catawba to numerous municipal and cooperative electric suppliers, Duke Energy Carolinas

agreed to purchase capacity from the co-owners in decreasing annual amounts over ten to fifteen years as their load grew to utilize their shares of the Catawba energy output. In the Company's rate proceedings in 1985 and 1986, both the SCPSC and the NCUC approved levelization of capacity costs related to these power purchases from the Catawba co-owners.

To avoid rate shock and to provide rate stability, the SCPSC approved a levelized approach to recovery of these costs and it chose to levelize the purchased capacity costs during the first half of the respective buy-back periods. Consequently, the SCPSC adopted a 5-year levelization period for the agreement with the cooperatives and a 7.5-year levelization period for the agreement with the municipals. However, the SCPSC required that, at the end of the levelization periods, a true-up would be made and rates would be adjusted to reflect the end of the levelization period. Order No. 85-841, Docket No. 85-78-E (October 8, 1985) at p. 34-42 (addressing Catawba Unit 1), and Order No. 86-116, Docket No. 86-188-E (November 5, 1986) (addressing Catawba Units 1 and 2) at pp. 43-45. The NCUC ultimately took a different approach and decided to provide in rates for the recovery of these costs by levelizing all of the Catawba purchased capacity costs over fifteen years. *Order Granting Partial Rate Increase*, NCUC Docket No. E-7, Sub 487 (November 12, 1991) at p. 55.

On May 10, 1996, the SCPSC approved a rate decrement rider to reflect an interim true-up of the Catawba levelization costs and certain demand-side management costs. *Order Approving Rate Decrement Rider for Interim True-Up of Deferral Accounts,* Docket Nos. 85-78-E, 86-188-E, and 91-216-E, Order No. 96-337 (May 10, 1996). This decrement rider provides an average 8% rate reduction and remains in place today. In North Carolina, the Catawba purchased power costs continued in part, through 2004 and were replaced by the accelerated amortization expenses associated with the North Carolina Clean Smokestacks Act discussed

above. As a result, the Company's NC retail rates and expenses effectively remained the same through 2007.

Due to these regulatory and legislative actions resulting in differing levels of Catawba levelization and environmental compliance costs, the Company's cost of service in South Carolina and North Carolina were significantly different. Thus, during the period 1996 through 2007, North Carolina rates were higher than South Carolina rates on average. After the reduction resulting from the 2007 NC Rate Order, the Company's North Carolina rates are now comparable to its South Carolina rates.

3. Duke Energy Carolinas' South Carolina Rates of Return On Equity Are Below 11%

Considering the settlement as a whole and in the interest of compromise, the parties to the NC Stipulation agreed to an 11.0% ROE, which the NCUC found to be just and reasonable as part of the overall settlement. Over the last three years, Duke Energy Carolinas has consistently earned rates of return on equity below 12.25%, its currently allowed ROE in South Carolina. In fact, the Company's average ROE as reported in its quarterly reports over the past eleven quarters has averaged below 11% as shown in the following chart.

Quarterly Filings
2005 through 2007

First Quarter 2005	11.58%
Second Quarter 2005	10.93%
Third Quarter 2005	12.00%
Fourth Quarter 2005	10.56%
First Quarter 2006	10.86%
Second Quarter 2006	9.69%
Third Quarter 2006	8.83%
Fourth Quarter 2006	10.79%
	10.37%

First Quarter 2007	
Second Quarter 2007	9.74%
Third Quarter 2007	11.53%
Average filed return	10.63%

Thus, Duke Energy Carolinas' actual ROE is consistent with the 11% ROE authorized in the NC Rate Order as well as the ROE authorized by the SCPSC for South Carolina Gas & Electric Company in its most recent rate cases – up to 11.4% in 2004 and up to 11.00% in 2007. Docket No. 2004-178-E, Order No. 2005-2; Docket No. 2007-229-E, Order No. 2007-885.

Numerous factors are placing upward pressure on Duke Energy Carolinas' rates, which are likely to decrease earnings and require a rate increase in the near future. The Company is entering into a period of major capital expenditures. Duke Energy Carolinas adds between 40,000 to 60,000 new customers annually. To ensure the availability of reliable electricity to serve existing and new customers, the Company must expand and modernize its existing generation fleet and transmission and distribution grid. These capital expenditures include planned generation additions, such as Duke Energy Carolinas' purchase of Saluda River Cooperative's ownership interest in Catwaba, new coal-fired and gas-fired generation and continued development of the Lee Nuclear Station, ongoing environmental compliance additions, as well as extensions and upgrades to transmission and distribution facilities.

4. The NC Rate Order Does Not Trigger the "Most Favored Nation" Clause in the Commission's Merger Order

This Commission adopted a Stipulation between Duke Energy Carolinas, the ORS and the South Carolina Energy Users Committee and approved the Merger in its Order Approving Stipulations and Merger, Docket No. 2005-210-E; Order No. 2005-684 (December 7, 2005) ("Merger Order"). The Stipulation included a merger savings provision under which the

Company proposed to reduce its South Carolina retail base rates for a one year period by $40 million, which constituted 42% of the five-year projected net merger savings allocated to the South Carolina retail jurisdiction. It also included a "most favored nation" ("MFN") clause which provides that:

> Following approval of the Merger by the state commissions of North Carolina, and Ohio, and approval of the affiliate agreements filed with the Indiana Utility Regulatory Commission in connection with the Merger, any sharing mechanisms pursuant to which merger savings are shared with retail customers in each of these states will be reviewed to identify the utility whose electric retail customers will receive the largest percentage of the net merger savings to be achieved over the first five years after closing of the merger allocated to that utility. If the application of that percentage to the net savings allocable to South Carolina retail would result in a greater savings sharing than $40 million, then the rate reduction . . . for South Carolina retail customers will be increased to match the application.

Merger Order, Order Exhibit 2 at p. 2. The SCPSC stated that: "We believe that all of these and other points in the Stipulation inure to the benefit of the South Carolina Duke electric customer, and, therefore, the adoption and approval of this Stipulation is in the public interest." Merger Order at p. 4.

In its order approving the Merger, the NCUC adopted certain provisions of a stipulation between Duke Energy Carolinas and the NCUC Public Staff. These provisions included the Company's proposal to share with customers, through a 12-month decrement rider, 42% of the five-year projected net merger savings assignable to its North Carolina retail customers – the same sharing percentage that results in the $40 million decrement approved by the SCPSC. The NCUC adopted a MFN provision similar to the one adopted by the SCPSC. The NCUC made clear that it had reviewed the orders of other state commissions addressing the Merger and that it did not intend to trigger the MFN provisions included in such orders. The NC Merger Order states: "none of the Regulatory Conditions imposed by the [NCUC] in this case will trigger any

of the 'Most Favored Nation' provisions in the other states and the [NCUC] has been careful to adopt no Condition which will trigger any of those provisions." NC Merger Order at pp. 74-75.

As discussed in Section III.B above, in the subsequent rate proceeding, the NCUC concluded Duke Energy Carolinas' test period operating costs should reflect an annualized level of merger cost savings actually experienced in the test period because rates should be designed to recover a reasonable and prudent level of ongoing expense. Therefore, the Company's annual cost of service and revenue requirement should reflect, as closely as possible, the Company's actual costs. This interpretation is consistent with the MFN provision in the South Carolina Merger Order.

The MFN provision speaks to "sharing mechanisms" adopted in orders providing for "the approval of the Merger by the state commissions of North Carolina, and Ohio, and approval of the affiliate agreements filed with the Indiana Utility Regulatory Commission in connection with the Merger". The South Carolina MFN provision was included as part of the merger approval to ensure that South Carolina customers were not disadvantaged and did not receive a lesser share of savings by virtue of the Commission having issued its approval of the merger earlier than the other jurisdictions.

The appropriate time period for determining whether South Carolina's level of shared savings was equivalent to other jurisdictions was at the time of consummation of the Merger, not some later time period or some subsequent general rate case proceeding in another jurisdiction. The treatment of merger savings in the North Carolina rate case was based on the NCUC's review of the Company's total costs of service, including operating expenses and merger savings, during the test period and did not involve any reconsideration of whether the Merger

should be approved. Review by the NCUC of Duke Energy Carolinas' cost of service in a rate case does not trigger the MFN provisions.

The NCUC recognized, however, that given the unique circumstances and timing of its rate proceeding, the application of longstanding general ratemaking principles and a strict application of its regulatory condition would lead to unfair results and results which were at odds with the earlier decision of the NCUC approving the allocation of 42% of merger savings to retail customers. Rate Order at p. 36. Therefore the NCUC decided to reconsider the language in the NC Merger Order which it perceived to bar an adjustment to base rates, a rate rider or other recovery mechanism related to merger savings. The NCUC calculated a 12-month rate increment rider to provide Duke Energy Carolinas' shareholders with 58% of the amount of merger savings included in base rates over the next three years. NC Rate Order at p. 37. This adjustment was made in an attempt to be consistent with the earlier decision in the Merger Approval Order. Whether Duke Energy Carolinas agrees or disagrees that the NCUC's solution goes far enough to produce a fair and equitable result is a matter for the rate proceeding and is not relevant to an analysis of the MFN provision in the order of the SCPSC approving the merger.

5. In the Case of Multi-Jurisdictional Utilities, the Rate Decisions of One Jurisdiction Should Be Based on Operations in that Jurisdiction Alone, and Should Not Be Influenced By the Results in Other Jurisdictions

Duke Energy Carolinas respectfully submits that on the core issues affecting rate determinations by the SCPSC (*e.g.*, operating costs, rate base, fair rate of return) the deliberations and determinations of the NCUC have limited, if any, relevance to the Company's South Carolina rates. The South Carolina Public Utility Law delegates to the SCPSC the power and jurisdiction to "supervise and regulate the rates and service of every public utility **in this State . . .** " S.C. Code Ann. §58-3-140, and it defines an electrical utility as an entity "owning or

operating **in this State** equipment or facilities for generating, transmitting, delivering, or furnishing electricity...." S.C. Code Ann. §58-27-10(7) (Emphasis supplied).

Although it appears that the Courts of South Carolina have not addressed this particular issue, the courts of those states that have done so have uniformly held that in the case of multi-jurisdictional utilities, the rate decisions of one jurisdiction should be based on operations in that jurisdiction alone, and should not be influenced by the results in other jurisdictions. The seminal decision on this point comes from the North Carolina Supreme Court. In *State ex rel. Corporation Comm'n v. Cannon MFG. Co.,* 185 N.C. 17, 28, 116 S.E. 2d 319,325 (1923), that Court said:

> [T]he Corporation Commission in this State is empowered and directed to make reasonable and just rates as applied to the distribution and sale of power in this State and not otherwise, and such power cannot be directly controlled or weakened by conditions existing in other states, either from the action or non-action of official bodies there, or the dealings between private parties. To hold otherwise would, in practical operation, be to withdraw or nullify the powers that the statute professes to confer and should not for a moment be entertained.

This decision was cited and followed by the North Carolina Supreme Court in *State ex rel. Utilities Comm'n v. Lee Telephone Company,* 263 N.C. 702, 709, 140 S.E. 2d 319, 325 (1965) ("When a company operates in two or more states, the operations are treated as separate businesses for the purpose of rate regulation.") As recently as 2006 the NCUC cited and followed these decisions in its order approving the merger of Duke Energy Corporation and Cinergy Corp. in Docket No. E-7, Sub 795, when it rejected the urging of certain industrial customers to reduce North Carolina industrial rates to bring them more in line with those in South Carolina. The NCUC said: "The Commission agrees with Duke Energy witness Hager that the reliance of CIGFUR III [Carolina Industrial Group for Fair Utility Rates III] on rate disparities between North Carolina and South Carolina, standing alone, is contrary to North

Carolina law." *Order Approving Merger Subject to Regulatory Conditions and Code of Conduct,* NCUC Docket No. E-7, Sub 795 (March 24, 2006) at p. 71.

Other states have reached the same result. *See, State of Alabama v. Alabama Public Service Comm'n,* 293 Ala. 553, 563, 307 So. 2d 521, 529 (1975) and cases cited there. *See, also, Re Manufacturers Light & Heat Co.*, 11 PUR 3d 28 (1955).

It is, therefore the revenues, costs, rate base and cost of capital as they pertain from time to time to the Company's operations in South Carolina that are relevant to determinations by the SCPSC as to the Company's rates in South Carolina. Thus, the NC Rate Order and the NCUC dockets in which it was issued do not provide a basis upon which to evaluate the reasonableness of the Company's current retail rates in South Carolina.

IV. CONCLUSION

This Report outlines historic rate making and legislative differences that have resulted in different cost of service and thus different rates in South Carolina and North Carolina and demonstrates that Duke Energy Carolinas' North Carolina rates after the reduction are now comparable to its South Carolina rates. The Report also shows that the Company's rates of return reflected in its quarterly filings over the last several years are below the authorized rates of return approved by the SCPSC and the rate of ROE authorized by the NCUC in the NC Rate Order. As demonstrated above, the NC Rate does not warrant any action by the SCPSC because: (1) the overwhelming driver resulting in the North Carolina rate decrease is the change in this the change in the rate treatment of costs associated with the North Carolina Clean Smokestacks Act, which are not currently included in South Carolina cost of service and rates; (2) the 11.0% ROE agreed to by the parties and approved by the NCUC as a party of the settlement is consistent with Duke Energy Carolinas' actual earnings reported in South Carolina over the last three years; (3)

the NCUC's treatment of merger savings in the NC Rate Order does not trigger the MFN provision adopted in the SCPSC's order approving the Merger; and (4) the remaining issues addressed in the NC Rate Order are specific to North Carolina and are therefore not legally relevant to rates and service in South Carolina.

Attorneys for Duke Energy Carolinas, LLC

Frank R. Ellerbe, III
Bonnie D. Shealy
Robinson McFadden & Moore
1901 Main Street, Suite 1200
Post Office Box 944
Columbia, South Carolina 29202
Phone: (803) 779-8900
Fax: (803) 252-0724
Email: fellerbe@robinsonlaw.com
bshealy@robinsonlaw.com

and

Lara S. Nichols, Esquire
Duke Energy Carolinas, LLC
526 S. Church Street, EC03T
Charlotte, North Carolina 28202
Phone: (704) 594-6200
Email: lsnichols@duke-energy.com